



Office of Thrift Supervision Foreclosure Prevention Proposal

Problem: Avoiding foreclosures of owner-occupied properties held in securitizations where a distressed borrower is unable to refinance a loan because the fair market value of the property is less than the current outstanding loan amount.

Objectives:

- Identify a market-driven solution that relies on existing programs, avoids a new government guarantee or assistance, and does not result in the transfer of unacceptable risk to the thrift's books.
- Ensure that the solution minimizes motivations for “gaming” the system by borrowers currently able to pay under their existing loan.
- Avoid providing a windfall to borrowers and investors in the securitization.
- Identify a solution that optimizes investor incentives/motivations to seek it out.

Solution: Implement a program where:

- Depository institutions offer and underwrite FHA-insured loans based on the current fair market value of the property;
- Proceeds of the new loan are used to provide a partial pay-off of the outstanding balance of the original mortgage loan to the holder of that loan; and
- Existing holders of the original loan receive a “negative equity interest” equal to the difference between the partial pay-off and the balance of the original mortgage loan held by the securitization pool. Alternatively, the negative equity interest could be shared among the existing loan holders, the FHA (or other entity protecting FHA's insurance risk), and/or the borrower/homeowner as needed to align incentives.

Pursuant to the program:

- The proceeds of the new FHA-insured loan would be used to pay off the original loan at a discounted payout (i.e., less than the original outstanding loan amount).
- The original loan holder would receive a negative equity interest (in the form of a non-interest bearing second position claim) equal to the amount of the discount between the new FHA loan and the unpaid balance on the original mortgage.
- Upon the subsequent sale of the property by the borrower, any appreciation in the value of the property (reflected in the sale price) above the discounted payout (i.e., the amount paid to the original loan holder with the proceeds of the FHA-insured loan) would be payable to the holder of the negative equity interest up to the full amount of that interest, with any sale proceeds beyond that amount accruing to the borrower.



Justifications/Rationale:

- Provides a market-driven solution that does not “bail out” investors or borrowers.
- Designed to maximize the servicer’s recovery of proceeds from the distressed borrower.
- Requires the original loan holder to take a lesser amount when the FHA loan closes, but not a dramatically reduced recovery such as that in a foreclosure of the original loan. This provides an incentive for the original loan holder to participate in the program.
- Avoids a windfall to borrowers by requiring any appreciation in a subsequent sale be paid to holders of the negative equity interest up to the amount of the discount that the original loan holders took when the original loan was cashed out.
- Relies on an existing framework – including the FHA-insurance – for addressing problem loans in securitizations.
- Creates a potentially marketable financial instrument in the negative equity interest.
- From a tax standpoint, this approach is neutral given that it does not involve forgiveness of debt because the borrower would still be on the hook for upside appreciation and the amount of loss would not be determinable until subsequent sale of the property by the borrower.

Example:

- \$220,000 subprime mortgage loan extended in March 2006 on residential property then appraised at \$240,000.
- Distressed borrower facing reset in March 2008 that will significantly increase the monthly mortgage payment; borrower will have difficulty making the payment at the reset monthly payment amount.
- Fair market value of the property is now at \$200,000.
- Borrower informs servicer of borrower’s financial distress pursuant to inquiry by servicer about the borrower’s ability to make the new (reset) payment.
- Servicer refers borrower to FHA-Insurance program at ABC FSB that will make a mortgage loan to the borrower at close to 100 percent of the current fair market value of the property (i.e., a \$200,000 mortgage loan).
- Servicer agrees to take \$200,000 partial pay-off in order to remove the existing subprime mortgage from the securitization pool, while restructuring the original loan and subordinating its position through retention of a \$20,000 negative equity interest that would be payable out of any appreciation in the value of the property (i.e., sale proceeds exceeding \$200,000) from proceeds of the future sale of the property by the borrower.
- Borrower has \$200,000 FHA-insured fixed interest rate loan with affordable monthly payment; and investors hold (and may sell) non-interest bearing \$20,000 negative equity interest in the property (i.e., a “zero-interest/coupon” second mortgage).
- If borrower sells property in 18 months at a sale price of \$236,000, the first \$20,000 of the \$36,000 difference (appreciation) between the sale price and the refinanced loan amount is payable to the investors (or other parties) on their negative equity interest in the property.